

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 91/77

3:00 p.m., June 7, 1991

R. D. Erb, Acting Chairman

Executive Directors

M. Al-Jasser
G. K. Arora

G. A. Posthumus

A. Végh

Alternate Executive Directors

D. Powell, Temporary
Chen M., Temporary
J. M. Abbott, Temporary
J. Prader
E. A. Evans
G. H. Spencer
N. Kyriazidis
M. B. Chatah, Temporary
I. Fridriksson
B. Esdar
T. Sirivedhin
G. Bindley-Taylor, Temporary
J.-F. Cirelli
O. Kabba
J. O. Aderibigbe, Temporary
P. Wright
G. P. J. Hogeweg
A. R. Ismael, Temporary
R. Marino
A. G. Zoccali
M. Nakagawa, Temporary

L. Van Houtven, Secretary and Counsellor
K. S. Friedman, Assistant

1. Income Position for FY 1991 and FY 1992 - Review Page 3
2. Operational Budget for June-August 1991 Page 22
3. SDR Department - Designation Plan for June-August 1991 Page 22

Also Present

African Department: S. N. Kimaro. Legal Department: F. P. Gianviti,
General Counsel: R. H. Munzberg, Deputy General Counsel. Treasurer's
Department: R. B. Hicks, B. E. Keuppens, J. McLaughlin, B. C. Yuen,
G. Wittich. Office of Internal Audit and Review: W. A. Beveridge,
Director. Advisors to Executive Directors: B. R. Fuleihan, J.-L. Menda.
Assistants to Executive Directors: B. A. Christiansen, J. A. Costa,
S. Gurumurthi, M. E. F. Jones, W. Laux, R. Meron, L. J. Morelli,
M. Mrakovcic, S. Rouai, J.-P. Schoder, N. Sulaiman, Tun Win, C. M. Towe.

1. INCOME POSITION FOR FY 1991 AND FY 1992 - REVIEW

The Executive Directors continued from the previous meeting (EBM/91/76, 6/7/91) their consideration of staff papers on the review of the preliminary results for the Fund's income position for FY 1991 and FY 1992 (EBS/91/67, 4/16/91; Cor. 1, 5/6/91; and Cor. 2, 5/8/91), the actual outcome for FY 1991 and the basic rate of charge for FY 1992 (EBS/91/86, 5/29/91), and a retroactive reduction in the rate of charge on the use of ordinary resources for FY 1991 (EBS/91/87, 5/29/91; and Cor. 1, 5/30/91).

Mr. Ismael stated that the improvement in the net income position of the Fund in FY 1991 was welcome, especially as it was the result of the settlement of deferred special charges, which indicated that the arrears strategy was bearing fruit. The net excess income for FY 1991 should be used to lower the rate of charge, as proposed by the Managing Director along the lines of the agreement reached by the Board at the time of the previous midyear review. That would be the most appropriate approach, as it would be consistent with the understanding reached when the surcharges were introduced. In addition, it would help to alleviate to some extent the debt servicing of members using Fund resources, as the actual rate of charge was too high, as previous speakers had mentioned. Furthermore, the strengthened debt strategy and the building up of the second contingency account were important factors that argued for that approach, as they provided additional protection for the Fund's resources. He supported the proposed decisions.

Mr. Spencer made the following statement:

On the matter of the retroactive reduction in the rate of charge for FY 1991, this chair supported the Board understanding reached in December last year. Since then, developments in income and expenses have been much as expected, and, therefore, we see no reason to deviate from that earlier understanding.

Mr. Abbott may well have a valid point about the fairness of the income distribution following late settlement of special charges. But I feel that this should not affect the decision for 1991, which is based on the existing agreed arrangements on burden sharing. Rather, the matter should be considered in the context of the overall review of burden sharing arrangements set for later this year.

Regarding the FY 1992 position, the key decision variable affecting the basic and actual rates of charge is the appropriate level of precautionary balances. This matter was touched on at the Board's discussion on burden sharing on April 5, 1991. At that meeting, while supporting the decision to continue with existing burden sharing arrangements for another year, I expressed the view, as Mr. Wright did this morning, that the Fund's reserves and provisioning policies should be reviewed in the near future.

I am particularly concerned that clearer targets should be specified for general reserves and special provisions in relation to total credit and in relation to the level and structure of nonperforming loans.

Once such targets are formulated, it would then be possible to focus the debate more clearly on the desired speed of adjustment toward the targets and, therefore, the requirement for reserve accumulation over the year ahead. In the absence of agreed objectives or, indeed, of any sort of analytic framework for addressing this issue, I fear that Board discussions on the rate of charge and burden sharing will continue to go around in circles. We will continue to debate how fast we should be travelling down the road without considering where we are actually going. Therefore, like Mr. Wright, I would hope that this question of a medium-term reserves strategy, or at least some sort of framework, will be considered by staff, either in the context of the review of burden sharing, or as a separate exercise.

In the meantime, there seems little point in revisiting the precautionary balances target for the end of FY 1992 that was implicitly agreed at our meeting on April 5. According to my calculations, the agreed increments to SCA-1 and SCA-2, combined with the proposal to add a further 5 percent to general reserves, will give an overall increase in precautionary balances in FY 1992 of 19 1/2 percent. Irrespective of what our destination might be, this seems to represent a fairly healthy speed of approach. Therefore, we support the proposed decisions.

Mr. Chatain made the following statement:

We can go along with the three draft decisions in EBS/91/85 as well as the proposed decision on a retroactive reduction in the rate of charge.

Regarding Mr. Abbott's proposal to add excess income in FY 1991 to reserves, we do not feel that such a course of action would be appropriate, for several reasons, although we understand the rationale behind the proposal. First, the staff's proposal is based on an understanding, reached during the midterm review, that unless the Managing Director considered another approach justified on the basis of changed circumstances affecting the Fund's financial position, any excess income would be used to reduce charges retroactively. Obviously management does not see a justification to do otherwise, and I am not sure that the fact that excess income is due primarily to the payment of special charges would fall under "changed circumstances in the Fund's financial position."

Second, since a retroactive increase in remuneration is not possible for the reasons given by the staff--and here I would be very interested in the Legal Department's response to Mr. Abbott's comments, which seemed to dispute the possibility of retroactively increasing remuneration, and assuming that the Legal Department's view is valid--the choice is really between reducing charges and adding to reserves. Given the level of the rate of charge, which is obviously quite high, and the rate of reserve accumulation and accumulation of other precautionary balances, we see a stronger justification for reducing charges. We should also remember that, in spite of burden sharing, not all costs to the Fund are being burden shared. And obviously the reserve target itself is carried by the rate of charge, or at least the increase in the rate of reserve accumulation from 3 percent to 5 percent that took place some five years ago and was related basically to the overdue obligations problem; at least that increase in the rate of reserve accumulation was also not burden shared.

Third, from a narrow distributional standpoint relating to special charges, the issue is admittedly a little more complicated, as the interest forgone by creditors and debtors through burden sharing is being recovered by debtors alone as and when special charges are paid. But this is the product of the way the system has evolved. Special charges to recover the direct cost to the Fund were introduced before burden sharing was established. With burden sharing, the direct cost to the Fund of overdue charges is eliminated at the point of deferral, when automatic adjustments to charges and remuneration take place. Nevertheless, the system of special charges has continued unchanged, with the result that the direct cost to the Fund, which is basically the interest on late charges, is being recovered twice, so to speak. It is for this reason that we have felt for some time that special charges on overdue charges should cease at the point of deferral. This would not only deal with the problem that prompted the Board to alter the system of special charges recently, but also avoid the situation we find ourselves in today. We recognize that there are mixed feelings about such an approach and similar approaches to deal with special charges in a fundamental way, since this may be misinterpreted as a relaxation of the arrears policy. But in our view, this is not an unsurmountable difficulty, and we may have a chance to come back to this soon during the discussion on special charges.

Mr. Nakagawa commented that his authorities understood some of the points that Mr. Abbott had raised with respect to the retroactive reduction of the rate of remuneration. But, as Mr. Wright had said, the present meeting was not the proper time to re-open that issue. His authorities were prepared to look at that issue during the comprehensive review of the

special charges. Based on the understanding reached at the time, his chair had supported the Board's decision at the midterm review in December 1990, and at the present meeting he would like to continue to respect that decision. In that spirit, his chair had no difficulty in supporting all the proposed decisions.

Mr. Bindley-Taylor recalled that, at the December 1990 midterm review of the Fund's income position, his chair, along with many others, had agreed that any excess income would first be used to reduce retroactively the rate of charge for the first half of FY 1991 to the level set for the second half of that year, and that any remaining excess would be used further to reduce the average rate of charge for the year as a whole. He continued to support that position. In addition, he endorsed the proposed rate of charge for 1992--95.7 percent of the current SDR rate--and the decision to leave unchanged the targeting of the Fund's net income at 5 percent of reserves at the beginning of the year.

The report at the end of FY 1991 showed SDR 31 million in excess of the original projected net income of SDR 70 million, Mr. Bindley-Taylor remarked. That outturn was due almost entirely to the unexpected large payment of special charges, which had more than compensated for the increases in administrative and remuneration expenses as well as reduced income from charges caused by lower than anticipated interest rates. However, the decision not to levy special charges on members following Fund-monitored rights accumulation programs would influence the level of unexpected payments of special charges in 1992. Therefore, it was quite possible that in 1992 the Board might not have to discuss what it should do with income in excess of the current projections.

During 1989, Mr. Bindley-Taylor continued, the rate of charge was set as a percentage of the SDR interest rate, and that approach had certainly reduced, in comparison with the past, the size of deviations from the targeted amount of net income. In light of that development, he wondered whether the time was not right to give more permanence to that approach to the setting of the basic rate of change.

Mr. Aderibigbe remarked that the Fund's income position for FY 1991 reflected an excess of SDR 31 million, or 44 percent over the projected target amount of SDR 70 million for the year. Given the fact that that large excess was accounted for by the settlement of deferred special charges, which had been omitted from income projections for the year because of their unpredictability, that outcome was close to expectation. Under the current mechanism, particularly the linkage between the rate of charge and the SDR interest rate, it had been possible to avoid wide deviations of realized from projected income and to maintain relative stability of the rate of charge, without jeopardizing the Fund's financial position. However, the current approach continued to make the rate of charge more market related, thereby pushing the cost of the Fund's ordinary resources beyond what most countries in his constituency could afford.

With regard to the use of realized income in excess of the target amount, Mr. Aderibigbe commented, he continued to support the understanding reached by the Board in December 1990, namely, that the excess should be applied retroactively to reduce the rate of charge for FY 1991 on the use of the Fund's ordinary resources. It would be fair and equitable if the excess was returned to borrowing members that had generated the surplus.

The assumptions on which the preliminary income projections and the rate of charge for 1992 had been based appeared reasonable, Mr. Aderibigbe said. However, he was somewhat concerned about the near doubling of projected purchases from SDR 5.4 billion to SDR 10.2 billion during 1992, even given the anticipated increase in demand from Eastern Europe. Could the staff explain the reason for the large increase?

In general, he recognized that the outturn of the Fund's income position in 1992 would be influenced largely by unanticipated developments during the year, Mr. Aderibigbe continued. It was expected that the usual periodical reviews would address problems that might arise. The influence of the timing of subscription payments under the Ninth General Review of Quotas on the Fund's income during the year had been emphasized. Could the staff say how significant the impact would be if there were a delay in concluding the quota increase in 1992? Finally, he supported the proposed decisions.

Mr. Marino made the following statement:

The actual outcome of the Fund's income position for FY 1991 corroborates the preliminary results presented in EBS/91/67 during mid-April, and is very much in line with the projections made during the midyear review of late November 1990 and discussed in early December. Therefore, we do not believe that it is appropriate to change the agreement on the disposition of net income for FY 1991 reached on that occasion. However, we concur with Mr. Abbot regarding the need to have a fundamental review of how to allocate special charges, given that they represent a financial cost to those countries that are most heavily taxed by the burden sharing decision. Fund accounting has become more complex since the arrears problem surfaced, leading to confusion about the relative contribution of each member country to the finances of the institution. We hope that the forthcoming seminar on burden sharing will help clarify all these complex interrelationships and lead to a proposal under which a simplified, transparent, and equitable system is devised, one that takes into account the dual role of many members as users and providers of resources, and as shareholders of the institution.

Regarding the decisions before us today, we think that the staff has presented a good case that there is an adequate balance between being cautious and recognizing the burden on the countries

using Fund resources and those that are net creditors. With regard to the precautionary measures, we agree with the staff that it is appropriate to continue additions to precautionary balances of 5 percent of reserves, and an equal amount to the SCA-1.

Under the burden sharing decisions, the rate of charge and the rate of remuneration will continue to be adjusted to make room for deferred income and to provide resources in the amount agreed to the SCA-2. All these measures combined are certainly strengthening the reserves of the institution and should give confidence to members of its solid financial foundation. However, we consider that the best precautionary action is to strive for a successful implementation of the rights approach in arrears countries and the timely and active support of donor countries for those member countries that are implementing strong adjustment programs in order to recover external viability and clear their accounts with the international financial institutions.

Perhaps too strong an emphasis on the need to increase precautionary balances might send the wrong signal to the financial community, as it would convey pessimistic expectations about the prospects for solving the arrears problem.

In any event, given the current situation, in which the burden of building up precautionary balances and the administrative costs of the institution fall mainly on debtor countries, that is to say, on countries that are in balance of payments difficulties, and given that it is widely recognized that the rate of charge on the use of Fund resources has been very high during the past few years, we strongly encourage the Treasurer's Department to put forth imaginative proposals on ways to alleviate the financial burden for users of Fund resources while safeguarding the financial strength of the institution.

All in all, the assumptions on which the projections for the income position in FY 1992 are based seem reasonable and cautious. Therefore, we can go along with the proposal to set the rate of charge at 96.6 percent of the SDR interest rate and with the other decisions in EBS/91/86.

Ms. Powell considered that Mr. Abbott's arguments were interesting, especially as she continued to have some reservations about the adequacy of the Fund's reserves. However, in view of the Board's previous discussion on the Fund's income position and the understanding that was reached at that time, she was not convinced that the issue that Mr. Abbott had raised should be re-opened at the present time. Therefore, she supported the staff proposal for a retroactive reduction in the rate of charge. She also supported the proposed decisions in EBS/91/86 relating to the disposition of

net income for FY 1991, the net income target and the rate of charge for 1992, and the review of the SDR rate of interest.

As to her general concern regarding the adequacy of the Fund's reserves, Ms. Powell continued, she, like Mr. Wright and Mr. Spencer, suspected that the time was ripe to have an indepth review of the Fund's exposure and the adequacy of the Fund's reserves. Such a review might help provide a better basis for determining the appropriate response to future unexpected increases in the Fund's income position, especially those related to payments of special charges. It would also provide an opportunity to reconsider the appropriateness of the 5 percent target that had been maintained over the past several years.

Mr. Esdar commented that the use of special charges and their nature had been a longstanding issue in the Board. Mr. Evans had made a good point when, in connection with the most recent discussion of the work program, he had mentioned that the Board should raise issues for further discussion only if there was a chance that Directors had changed their views since the previous discussion. When the Board had discussed the Fund's income position in December 1990, it had reached a reasonable compromise, which was reflected adequately in the staff's current proposal. There were no new facts that could lead to a change in view, and, therefore, the proposed decision involving special charges was acceptable. He also supported the staff proposal to increase reserves by 5 percent and its related implications for the basic rate of charge. That target was certainly adequate and justified, given the present economic environment. Finally, there should be no changes in the calculation of the SDR interest rate.

Mr. Posthumus made the following statement:

Today, of course, we are discussing what the financial position of this institution is and what we should do about it, and not the desirability of lower charges in general; and I would like to very specifically make the distinction between these two subjects. The latter has been mentioned by several speakers today, and, in a general, structural sense, I agree with them that it would be desirable to have somewhat lower charges; but that is an altogether different issue. In my view, today the overriding element is that it is our responsibility to have a look again, by the decision which we take today, at the financial position of this institution.

I remain concerned--as does the staff--about the financial and reserve positions. The arrears situation may have improved somewhat, but it is certainly not true that a solution to all the arrears cases is even in sight. I am not sure that we took a useful step by extending the deadline for the introduction of rights accumulation programs, and I am afraid that we may have to extend that deadline again. In fact, I wonder whether that

decision itself does not always give us the obligation to have another close look at the reserve situation and perhaps take some measures to improve it. This is the general approach I bring to today's discussion.

A number of Directors have noted that the retroactive reduction of the rate of charge was agreed at the midterm review in December 1990, on the basis of an understanding reached at that time. But it is not necessary to treat that agreement as if there were some sort of taboo against talking about it at the present stage. At first sight, the proposal Mr. Abbott made today seemed reasonable; now, at the end of the round of discussions today, I have the feeling that there is not much support for that idea, at least not at this moment. But I would very much like to hear what the staff has to say about Mr. Abbott's arguments. And even if we do not resolve this issue today, which seems likely, I would like to know when can do so. Need we have a special meeting for that purpose? Could the discussion on that issue be part of the discussion on the broad principles of burden sharing that we plan to hold at the end of the year? At first sight, I tend to feel that it is not part of that broader discussion; it is a more specific topic that could be discussed much earlier.

Finally, some further strengthening of the Fund's reserve position would be useful. I would like to ask the staff to look at that position from the point of view of the possibility that there may be a few arrears cases that cannot be solved, in which event something else would have to be done, which we have not discussed so far but about which we have a staff document. We may have to use the reserves at a certain stage, and it is from that point of view as well that we should look at the adequacy of the Fund's reserve position.

Mr. Fridriksson stated that his chair supported all the proposed decisions, including the one based on the understanding reached in December 1990.

Mr. Chen said that, with respect to the disposition of the actual net income for FY 1991, and in accordance with the understanding reached by the Board during the midyear review of the Fund's income position in December 1990, he continued to support the decision that any amount of net income in excess of the target should be used to reduce retroactively the rate of charge on the use of ordinary resources. He continued to believe that such an arrangement was still appropriate at present. He could also go along with the proposed decision placing about SDR 70 million to the Fund's Special Reserve from the actual net income. With respect to the mechanisms for setting the target net income and adjusting the SDR interest rate, they

had been working well thus far, and there was no obvious need to change them. Therefore, he had no difficulties with any of the proposed decisions.

Mr. Kyriazidis said that he could go along with all the proposed decisions. With regard to the retroactive reduction of charges, there was at present no reason to change the understanding reached at the midterm review in December 1990. However, Mr. Abbott's points should be discussed at the appropriate time.

Mr. Al-Jasser made the following statement:

I support the proposed decision to retroactively reduce the rate of charge as a result of the income in excess of the target amount. The fact that this excess income results from the settlement of current and overdue special charges does not provide sufficient grounds for the Executive Board to rescind the understanding reached at the midyear review. However, I share Mr. Abbott's concern about the fact that these special charges are related to the forgone income by contributors to burden sharing, creditors and debtors alike. Nevertheless, my support for the proposed decisions is based on the following considerations, on which I hope the staff would elaborate.

The Executive Board has considered that an annual increase in the Fund's precautionary balances of 5 percent of reserves was adequate. This led to the determination of an income target of 5 percent of reserves, irrespective of where that income emanated from. Hence, if we were to allocate the excess income to reserves, this would imply that our initial income target was insufficient. Consequently, one would question the wisdom of adding only 5 percent of reserves to the Fund's precautionary balances. In my view, the adoption of the rights approach, as well as the decline in the number of arrears cases, have improved the financial position of the Fund and in no way justify an increase in the income target. Therefore, any increase in the reserves beyond the income target would send the wrong signal, in that it would indicate that the Fund's financial position had recently deteriorated or that it was worse than initially acknowledged. Either one of these signals will have serious repercussions.

The strongest argument against allocating the excess net income to reserves emanates from the fact that, had special charges been considered in the income projection, the basic rate of charge required to attain the agreed upon net income target would then have been lower than that set at the beginning of the

period. Therefore, logically, it follows that once these special charges are paid, they should be used to retroactively reduce the rate of charge.

I recognize that the current treatment of special charges raises complex issues of equity and fairness. Ideally, it would have been more transparent to treat special charges and charges identically. While this was not undertaken to avoid higher adjustments under burden sharing when special charges were unpaid, it led to the apparent inequity problem. Nevertheless, had special charges been included in the income projections, that would have led to a lower basic rate of charge. Furthermore, in the unfortunate event that special charges are not paid, they will have to be subject to burden sharing. However, when these overdue special charges are actually paid to the Fund, the proceeds will be equitably reimbursed to the contributors of burden sharing. The net distributional result of this operation is identical to the current staff proposal in that the basic rate of charge would be reduced, while the burden shared amounts were refunded. In the staff proposal, we omit the intermediate step of burden sharing the amount and reimbursing that part which is eventually repaid.

The staff representative from the Treasurer's Department recalled that Mr. Abbott had raised a number of questions on the staff's analysis with respect to special charges. The staff intended to study Mr. Abbott's remarks carefully before responding to them in full in writing in the coming months. For the time being, he wished to make several points in response to Mr. Abbott's remarks as well as those of other Directors.

The staff certainly agreed that, even though members that contributed to burden sharing would eventually receive refunds, those countries did bear a real burden in terms of income forgone in the period until the refunds could be made, the staff representative commented.

As Mr. Abbott had noted, the staff representative said, special charges were not included in the staff's projections of income. The rate of charge was computed on the basis of the projected amount of income and the Board's decision on the net income target for a financial year. To the extent that special charges were not included in the projections of income, the amount that needed to be generated by the rate of charge on ordinary resources was larger than it otherwise would be and, therefore, the rate of charge on ordinary resources was higher than it otherwise would be. It was in that sense that the staff felt that the rate of charge was higher than it otherwise would have been if the staff had in fact made such projections. Special charges were not currently included in income projections because the likelihood that any special charges would be paid was small and because there was no reasonable way to estimate how much was likely to be paid. Several years earlier, the staff had tried to make projections of special

and deferred charges, but the estimates had always been so far off the mark that the Board had decided that it would be better to devise another system, as the Fund's income had been subject to considerable fluctuation because of that estimation problem. If the staff were able to make correct projections of payments of special charges and they were included in projected income, then, of course, there would not be any net income in excess of the target amount deriving from the settlement of special charges. If the staff made a projection that a specific amount of special charges would be paid and the actual payments were smaller, then the Fund's income would be too low and the target amount of income would therefore not be met, unless the special charges were also subject to burden sharing. In that case, the contributions under burden sharing, which were provided by creditors and debtors, would make up for the shortfall that occurred when the special charges were not paid. The staff would describe the situation with respect to special charges in greater detail in its full response at a later stage, as Mr. Abbott, Mr. Wright, and other Directors had requested.

Third, it was of course true, as Mr. Abbott and some other Directors had pointed out, that special charges had helped to meet the net income target, the staff representative went on. In fact, in FY 1991, had it not been for payments of special charges, the Fund would have fallen short of the net income target. The special charges paid during the year had amounted to the equivalent of about SDR 40 million; the excess was SDR 31 million. Hence, actual net income would have fallen short of the target by about SDR 9 million.

A number of Directors had referred to the variability of the Fund's income position in the past and to the discussion in the Board that had invariably ensued either because there were shortfalls and the target amount had to be higher in the subsequent years, as was the case in FY 1990, or, as was the case in FY 1991, there was an excess in income and its disposition had to be determined, the staff representative remarked. The only way the staff could conceive of to ensure that target income would be met exactly, and those debates could be obviated, was to set the rate of charge retroactively, at the end of a financial year, when all the relevant facts were known. That actually was the case with charges on borrowed resources, which were determined retroactively on the basis of the costs the Fund incurred for its borrowing. That possibility had been discussed by the Board several years before, when a number of Directors had felt that the uncertainty as to the charges to be incurred suggested that such a system would not be advisable. Perhaps the balance of advantages and disadvantages of a retroactive determination of the rate of charge had shifted since then, and that alternative for setting the rate of charge might usefully be re-examined in the coming months.

There remained the question of income forgone by members that contributed to burden-sharing, the staff representative commented. Thus far, the Board had not considered that it would be desirable to in some way make up for such income forgone during the period that burden shared amounts

were with the Fund. But that option was clearly a possibility, although the resources to be used for that purpose would need to be generated one way or another--either through windfalls, as was the case in FY 1991, or through higher rates of charge.

Some speakers had questioned whether the target of 5 percent of reserves should not be increased, the staff representative recalled. During the recent discussion on burden sharing, Mr. Landau had taken the opposite position, arguing that the reserves were already too high and that the target might be reduced. The staff considered that the Fund's financial situation had improved, but not in such a way that one could feel comfortable in concluding that there was no need for a further increase in reserves at the present stage. Therefore, the staff had suggested that it would appear appropriate to continue in FY 1992 the rate of accumulation prevailing in FY 1991. At the same time, the staff agreed with those Directors who had suggested that the situation should be looked at again before determining the income target and the rate of charge in the coming financial year. In that connection, it was useful to note that total overdue obligations to the Fund in the General Resources Account were about SDR 3.1 billion. Of that amount, about SDR 1 billion was deferred charges. For that latter amount, it was the members that had contributed to burden sharing that were exposed, rather than the Fund. The risk of loss for the General Resources Account related to overdue repurchases (about SDR 2.1 billion was overdue), and the total exposure to countries in protracted arrears was about SDR 2.6 billion. In other words, there was about another SDR 400 million of credit outstanding to members with protracted arrears that had not fallen due yet but would do so in a relatively short period.

The amount of SDR 2.6 billion that he had mentioned was owed by a rather diverse group of members, the staff representative continued. For several countries, little progress had been made under the cooperative approach; the exposure to those countries was about SDR 920 million. The position with respect to another two countries--with arrears of about SDR 250 million--was not clear at present; some progress had been made, but the outlook was uncertain. For a larger group of members, stabilization programs, rights accumulation programs, or other adjustment policies were in effect and most of those countries were meeting their current obligations as they fell due. Those members still had arrears, but it was hoped that they would be settled at the end of a rights accumulation program; total arrears of those members totaled about SDR 1.3 billion. Finally, two members had settled protracted arrears under the cooperative approach. There thus had been a notable change in the overall arrears situation compared with FY 1990, when fewer countries had made as much progress with their policies and were meeting their obligations in full as they fell due. It was in that respect that the staff felt that the precautionary balances were currently somewhat more comfortable than in FY 1991 and certainly than they were three or four years earlier. The staff would not say that the Fund's financial

position was fully satisfactory--there remained uncertainties, even about some of the arrears countries with rights accumulation or other adjustment programs. Nevertheless, the situation had clearly improved.

Another aspect of the Fund's reserve accumulation had been mentioned by Mr. Spencer, which was particularly difficult, the staff representative commented. A number of years earlier, the Board had extensively discussed precautionary balances, the need for provisioning, and how to determine the necessary amounts. A number of staff papers had looked at various formulas relating to the level or desirable increase of reserves to credit outstanding, to arrears, and to the various magnitudes that Mr. Spencer had mentioned. The Board at that time had decided that it was undesirable to adopt any fixed formula, for the reasons that he had mentioned at the present meeting; the qualitative factors in the situation were such that they could not be captured by those types of relationships. However, the question of the reserve target for subsequent years could be re-examined by the Board if it so wished.

The staff could not say with any precision how much of the special charges falling due in the coming year would actually be paid, the staff representative said. The amount would most likely be much less than in FY 1991, because the payments in FY 1991 included special charges paid by members in arrears that settled current obligations as they fell due--for example, Peru and Panama. The Board's recent decision to lift special charges on members with ongoing programs would reduce the amount in FY 1992 compared with FY 1991. There was, of course, still a large amount outstanding, and to the extent that any of the members concerned were to pay past arrears, including special charges, there could be an amount of income that had not been taken into account in the staff's projections.

The staff's projections did include all the repurchases by members that were in arrears but were remaining current in their obligations as they fell due, the staff representative commented. The staff had excluded only repurchases of the several members in arrears that did not yet have an adjustment program. That exclusion was made because the staff could not project with any confidence that the payments would be made during the coming year, and the effect on the Fund's income was in any event not large, as presumably members would continue to pay charges, or at least accrue charges, which were settled through the burden sharing mechanism; hence, the effect on the Fund's income was a small one reflecting the difference between the rate of remuneration and the rate of charge.

The staff's current projection of a substantial volume of purchases in the coming financial year was based on the usual survey by the area departments of likely purchases and the staff's analysis of the effect on the Fund's liquidity, which the Board had discussed in March 1991 and would be discussing again soon, the staff representative remarked.

The effect of the Ninth General Review on the Fund's income was very difficult to project, the staff representative from the Treasurer's Department said. It depended completely on the timing and use of the increased quotas, which had not yet been taken into account. Of course, the later in the financial year that the increase took effect, the smaller the effect would be on the Fund's income.

Mr. Spencer commented that any financial institution obviously faced difficult qualitative factors in making provisions and setting targets for reserves, but some sort of decision eventually had to be made. The main issue was not whether there would be a decision on what sort of precautionary balances were needed, but rather when that decision should be taken. It was best to try to make the assessment underlying that decision in the context of some sort of rational framework ahead of time, as opposed to making it on an ad hoc basis from one Board meeting to the next.

Mr. Abbott said that it was somewhat discouraging to be reminded of Mr. Evans's advice that the Board should avoid discussing an issue when it was unlikely that views on the issue had changed since the previous discussion. At the same time, he was pleased that some Directors-- Mr. Posthumus, for example--had indicated that they were open to further considering the issues that he himself had raised at the present meeting.

There was in fact no way of avoiding the equity issues that he had raised in his opening remarks, Mr. Abbott continued, but the main point of those remarks was the questionable logic of the proposed decision and the staff's assertion that the excess income in FY 1991 was attributable to members paying charges in FY 1991. The purpose of his statement was to examine the accuracy of that assertion. He had concluded that, in carefully looking at the nature of the special charges, the opportunity costs involved in burden sharing, and the residual uncompensated financial costs borne by creditor members, the staff's assertion was clearly inaccurate. It might happen that, after all, with the excess income being generated on the basis of the participation of all the members, the Board would still wish to conclude that the excess income should be allocated to reduce charges. His argument was that it did not follow from the nature of the operations concerned that the special charges were attributable to the members paying charges; the logical problem with such a conclusion should be examined. His chair had asked for a review of that matter on a previous occasion, and he was pleased that the staff now intended to do so. Other Directors, too, would like to see that issue clarified. Having listened to the staff's comments at the present meeting, he still felt somewhat uncertain about the interpretation of ultimate compensation under the burden sharing formula. The staff apparently considered that, at the final payout, when all the special charges were settled, the remuneration would be made whole--backdated to 100 percent of the SDR interest rate. One of his own points was that that analysis was incomplete. It was true that the remuneration would again be 100 percent of the SDR interest rate, but the creditors would not recover their out-of-pocket expenses of the extra borrowing necessary to

finance their contribution to the burden sharing. That cost would be permanently uncompensated loss for those members. He wished to know whether there was a common understanding that the nature of the way the system of special charges worked was consistent with his description of it.

As the staff had noted, the exclusion of anticipated receipts of special charges from the income projections led automatically to a pushing up of the rate of charge necessary to ensure that the income target would be hit, Mr. Abbott commented. That conclusion was a matter of arithmetic. The staff had also remarked, as a counter example, that if those receipts were anticipated but not actually realized, the income receipts would be below target and, if low enough, the Board would have to assess members in order to reach the target. The procedure for doing so would involve a levy of some sort on charge payers and creditors, and the procedure should work symmetrically. In fact, it did not work symmetrically. The proposal on the table at the present meeting was that all of the excess for FY 1991 should be applied entirely to the charge payers. There was something askew in that arrangement--it was illogical to attribute the entire amount to one class of members. That matter needed to be clarified. In addition, he agreed that a clarification of the accounting methods involved would be useful; it was difficult to track through the incremental adjustments to categories, and a simplified system would be welcome.

The staff representative from the Treasurer's Department said that the staff was making every effort to present the system as clearly as possible. Part of the problem in that connection was that the system was complex. Whether or not the system was symmetrical depended very much on which factors one took into account. The example that he had presented supported the view that the staff had taken. One year earlier, the income shortfall at that time had been made up by increasing the net income target and thereby increasing the rate of charge, and the cost thus had not been borne by creditors and debtors.

The paper that the staff planned to present in the coming period would address, inter alia, the logic of the system, the staff representative from the Treasurer's Department commented. The difference between the analysis of Mr. Abbott and that of the staff essentially revolved around the definition of "special income." The staff had not differentiated between income from special charges and other income, e.g., a surplus derived from other unanticipated factors and available to meet the net income target. For instance, if during the coming year the SDR rate of interest were to rise significantly, there would presumably be an excess of income that was in effect a windfall and which would be available for the Board's disposition. The staff's analysis had started from the Board's decision on a specific target amount of income; the rest followed from that target amount. Hence, in making the analysis that Mr. Abbott had in mind, one had to decide whether special charges were a special kind of income for a special purpose and should be treated differently from other forms of income. If so, then the income that had to be generated by the rate of charge would be greater

even if there were special charges that needed to be paid. He had not meant to suggest that the contributors were made whole in the sense of receiving coverage of all their expenses as contributors; it was clear that the income forgone on those resources was borne by the creditor and debtor countries that had contributed under burden sharing. The limits under the Articles under which the rate of remuneration could not exceed the SDR interest rate did not make allowance for an additional factor which would compensate for interest forgone on those balances of remuneration which were not paid when they in some sense should have been paid.

The Deputy General Counsel commented that, at the present meeting, the Board was being asked to determine the net income and to decide on its disposition, and not on the distribution of the proceeds of special charges. In accordance with Rule I 6(4), there were several possible avenues for using the income in excess of the target amount--to reduce the rate of charge retroactively, or increase retroactively the rate of remuneration, or to add to reserves, as Mr. Abbott had proposed. The question, therefore, was whether, under the present rules and given the fact that the proceeds of special charges were part of net income, the excess income could be used retroactively to increase the rate of remuneration. The answer to that question was in the negative, because the rate of remuneration was set--since February 1987--at 100 percent of the SDR interest rate. Such a reduction would apply to the "basic" rate of remuneration, like a retroactive reduction of the rate of charge would apply to the "basic" rate of charge, and not to the adjusted rate of charge, i.e., after adjustments for burden sharing--or the rate of remuneration after the adjustments.

The staff would look again at the issue of the cost of the burden sharing, as Mr. Abbott had requested, the Deputy General Counsel said.

Mr. Wright said that he had two main points in mind. First, while he felt uneasy about the 5 percent target for reserves having remained unchanged for so long, he was unclear about how to judge the appropriate level. He, like Mr. Spencer, would welcome a more systematic framework for assessing the adequacy of the Fund's reserves.

The second point concerned retroactive adjustments to the rate of charge, Mr. Wright continued. The current discussion had clearly served to remind Directors of the uncertainty of the staff's income projections. The staff had noted that the income projection for the previous year had been achieved only because of the essentially random event of the payment of special charges during that year. For that reason, the Board should be cautious in making decisions about the disposition of excess income at the time of the midyear review. The Board was obliged to examine the issue of the Fund's income position if there was a shortfall projected because of the impossibility of increasing the rate of charge retroactively. But it seemed unwise to allocate an excess on the basis of an understanding reached at the time of the midyear review. The risk in so doing at the present stage might be smaller once the status of the special charges was clarified as a result

of the paper that the staff intended to prepare. Meanwhile, the uneasiness that he felt about being able to judge the income position had been reinforced by the reminder of the uncertainty surrounding the income projections.

Mrs. Sirivithin said that she wondered whether there was any way in which to separate special charges from net income, so that they could be allocated back to creditors and debtors that had participated in burden sharing, instead of being subject to the rules on net income.

The Deputy General Counsel responded that the staff would look at that matter in a forthcoming paper. One possibility that had been considered in the past in associating repayments to particular member groups was that, from the outset, a contribution was made and associated with certain events that would lead to repayment, such as the special contingent accounts or the deferred income payments, which had permitted the separation of transfers from net income. Otherwise, payments would be part of the Fund's income when received, unless there was a particular obligation that must be met.

Mr. Chatah commented that he agreed with the Deputy General Counsel that the Board was being asked on the present occasion to look at the pre-adjusted rate of remuneration, for which there was a ceiling of 100 percent of the SDR interest rate. He wondered whether it followed that the 80 percent floor under the Articles should also be treated the same way, so that the floor would apply to the pre-adjusted rate, not the adjusted rate, which would make the floor more flexible than it might have been thought to be in the past.

The Deputy General Counsel replied that the distribution under the burden sharing mechanism constituted a delayed payment which corresponded to the adjustment of the rate of remuneration that had been made during a previous period.

Mr. Chatah commented that the issues under discussion were complicated. He took the staff to mean that 100 percent of the SDR interest rate was actually the pre-adjusted rate of remuneration. While he understood that fact, he wondered why the ceiling and the floor for the rate applied to the post-adjustment rate.

The General Counsel said that the staff calculated for one particular financial year a rate of remuneration, 100 percent of the SDR interest rate, which, in theory, was the pre-adjusted rate. The adjustments under burden sharing would then reduce the remuneration rate to no more than 80 percent of the SDR interest rate. At the same time, the up to 20 percent that had been deducted gave rise to an obligation for a further payment at a later date to the creditors. When in a subsequent year that amount became available, it was payable in addition to the remuneration for the subsequent year. Therefore, in the subsequent year, a rate of more than 100 percent of the SDR interest rate would be paid, namely, 100 percent for that year plus

the up to 20 percent from the former year, which would be made as a payment under an obligation, not as remuneration for that year; it would be a delayed payment of remuneration earned by the creditor in the former year.

The Acting Chairman commented that it might be useful to recirculate certain staff papers for previous discussions on the issue of the reserve target and then determine whether and when there should be a further discussion of the issue.

The Executive Board then approved the following decisions:

Retroactive Reduction of Rate of Charge for FY 1991

Net income for financial year 1991 in excess of the target amount of 5 percent of the Fund's reserves at the beginning of that financial year shall be used to reduce retroactively the proportion of the rate of charge to the SDR interest rate specified in paragraph 2 of Decision No. 9457-(90/89), adopted June 8, 1990, for the period May 1, 1990, to October 31, 1990, to 87.8 percent, and any excess amount remaining after such reduction shall be used to reduce further the proportion for the period May 1, 1990 to April 30, 1991.

Decision No. 9749-(91/77), adopted
June 7, 1991

Disposition of Net Income for FY 1991

The Fund's net income for FY 1991, equal to SDR 69,848,835, shall be placed to the Special Reserve.

Decision No. 9750-(91/77), adopted
June 7, 1991

Net Income Target and Rate of Charge for FY 1992

1. In accordance with Rule I-6(4)(a), the target amount of net income for FY 1992 shall be 5 percent of the Fund's reserves at the beginning of the financial year.

2. During FY 1992, and notwithstanding Rule I-6(4), the rate of charge referred to in Rule I-6(4) shall be a proportion of the SDR interest rate under Rule T-1.

3. Effective May 1, 1991, the proportion shall be 96.6 percent.

4. In accordance with Section IV, paragraph 3 of Decision No. 9696-(91/49), adopted April 5, 1991, a midyear review of the Fund's income position shall be held shortly after October 31, 1991. At that time, the proportion of the SDR interest rate shall be reviewed on the basis of (i) the then prevailing SDR interest rate, and (ii) the revised estimated income and expense of the Fund during the year and the target amount of net income for the year. If after any adjustments under Section IV, paragraph 2, of Decision No. 9696-(91/49) actual net income for the first six months of the financial year, on an annual basis, is below the target amount for the year by an amount equal to, or greater than, 2 percent of the Fund's reserves at the beginning of the financial year, the Executive Board will consider how to deal with the situation. If by December 15, 1991 no agreement has been reached as a result of this consideration, the proportion of the SDR interest rate shall be increased as of November 1, 1991 to the level necessary to reach the target amount of net income for the year.

5. When estimating income, no deduction shall be made for projected deferred income.

6. The Executive Board shall be notified, shortly after the end of each quarter, of the average rate of charge for the quarter.

Decision No. 9751-(91/77). adopted
June 7, 1991.

Rate of Interest on SDRS - Review

Pursuant to Rule T-1(d), the Executive Board has reviewed the rate of interest on holdings of SDRs.

Decision No. 9752-(91/77) S, adopted
June 7, 1991

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/91/76 (6/7/91) and EBM/91/77 (6/7/91).

2. OPERATIONAL BUDGET FOR JUNE-AUGUST 1991

The Executive Board approves the list of members considered sufficiently strong as set out in EBS/91/82 (5/24/91), page 2, footnote 1 and the operational budget for the quarterly period beginning June 10, 1991 as set out in EBS/91/82 (5/24/91) and Supplement 1 (6/12/91).

Decision No. 9753-(91/77), adopted
June 7, 1991

3. SDR DEPARTMENT - DESIGNATION PLAN FOR JUNE-AUGUST 1991

The Executive Board approves the designation plan for the quarterly period beginning June 10, 1991 as set out in EBS/91/83 (5/28/91).

Decision No. 9754-(91/77) S, adopted
June 7, 1991

APPROVED: December 4, 1991

LEO VAN HOUTVEN
Secretary